ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Fidelity Goes Short in High Yield

It what appears to be a reaction to the current bond market environment, Fidelity filed plans with the SEC this week for a new fund—Fidelity Short Duration High Income—which the firm expects to open later this year. As indicated by the name, the fund's goal is to provide a high level of current income, but it also has a secondary goal of capital appreciation. The announcement comes at a time when many investors are looking for higher-yielding fixed-income investments that also have a margin of safety built in for when interest rates start rising.

Short Duration High Income will focus on three segments of the bond market: High-quality high-yield bonds, floating rate loans and investment-grade corporate bonds. Duration will be limited to less than 3 years in an attempt to limit the impact of interest-rate risk. Meanwhile, overall credit quality will be kept in the B to BB range to manage the risk of default.

Fidelity has lined up Matt Conti to serve as lead manager of the fund; he will handle the high-yield and floating rate loan portions of the portfolio, while co-manager Michael Plage will be responsible for the investment-grade corporate sleeve. Conti currently manages Fidelity's Focused High Income fund and is also a co-manager on a number of the firm's other bond offerings. Plage co-manages Fidelity's Corporate Bond fund.

The addition of Short Duration High Income will expand Fidelity's suite of high-yield fixed-income funds to six, which already includes a floating-rate fund (Floating Rate High Income), three broader options (Capital & Income, Focused High Income and High Income) and a global fund (Global High Income). Of the domestic funds, only Capital & Income has no restrictions on credit quality (the rest have a B/BB-rated or better mandate), but all of them are currently positioned towards the medium- to high-quality end of the spectrum, which is likely a reflection of Fidelity's outlook for the overall bond market and the high-yield space. Looking at the existing funds' maturities, they all fall into the intermediate-term space on the yield curve—Short Duration High Income will be limited almost exclusively to securities with a maturity of less than 5.5 years, meaning its portfolio should have a short-term focus overall.

In This Issue

The initial objective laid out by Fidelity in the SEC filing seems to be consistent with its somewhat conservative approach to the high-yield space, but the shorter-duration emphasis of the new fund fills an empty niche in the lineup, and as such, we think it bears watching once it opens to new investors.

Vanguard Adds to Explorer

For the third time in its history, Vanguard's small-cap focused Explorer fund has seven separate management teams each running a portion of the portfolio, a somewhat dubious distinction.

On August 12, Vanguard announced the addition of Ryan Crane of Stephens Investment Management to the fund's team of managers. Stephens, which uses a combination of fundamental research and computer-driven quantitative modeling to pick stocks for its strategies, is new to the Vanguard fold. While Vanguard hasn't revealed the exact numbers, it indicated that Crane will initially be overseeing a "modest" portion of the fund, which should grow over time, presumably with inflows and capital appreciation.

Crane currently manages two funds for American Beacon, the Stephens Small-Cap Growth fund and the Stephens Mid-Cap Growth fund, and leads Stephens' small cap growth, mid cap growth and small-mid growth separately managed account strategies. Looking at the track record of the small-mid growth strategy in comparison to Vanguard Explorer, the Stephens strategy has outperformed since 2005. However, with only that "modest" slice of Explorer's overall portfolio, it's doubtful that Crane will have a meaningful impact on the fund's performance.

While the Explorer fund does have a few top-notch managers running pieces of the portfolio, as more and more teams have been added to the fund over the years, they have been increasingly lost in the crowd. What was once a solid fund has been bogged down by manager bloat and performance has suffered as a result.

We believe Vanguard would be much better off giving quality managers new funds to manage instead of bundling them up on existing products where their contributions will be diminished or even insignificant. Unfortunately, Vanguard remains committed to the multimanager approach, one that Adviser Investments avoids in our client portfolios with very few exceptions.

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